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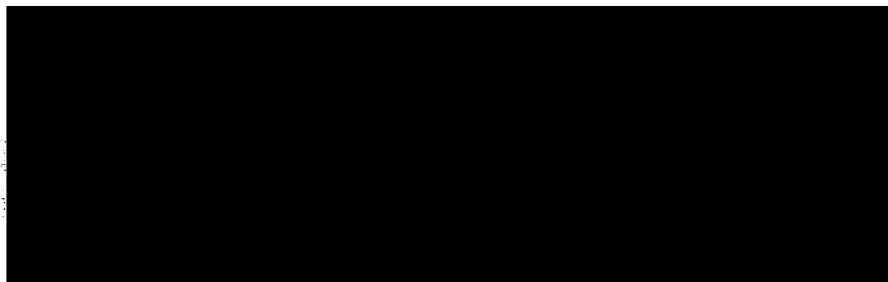


**Directorate of  
Intelligence**

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# **Japan: Marking Time in Economic Relations With the USSR** [REDACTED]

**An Intelligence Assessment**



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EA 83-10095  
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## Japan: Marking Time in Economic Relations With the USSR [REDACTED]

### Key Judgments

*Information available  
as of 17 May 1983  
was used in this report.*

Moscow's harsh reaction to Prime Minister Nakasone's moves to strengthen ties with the United States, particularly in the military field, and Tokyo's hardline response militate against any significant improvement in relations for some time to come. [REDACTED]

Domestic pressure for better economic relations is at a low point. Business interest in the Soviet market has faded as recession and other problems have reduced demand for Soviet raw materials and energy. The Japanese Government and private investors in the Sakhalin offshore oil and gas project do appear determined to move ahead, although prospects for new Siberian resource development projects are dim. In 1983 total trade between Japan and the Soviet Union is likely to rise at well below the 16-percent rate (year-to-year comparison of yen values) of 1982. [REDACTED]

[REDACTED]

The Nakasone administration's efforts to strengthen ties with the United States have also produced a willingness to cooperate in the enforcement of economic sanctions against the USSR. The Japan Export-Import Bank has made no major new commitments to Moscow since the declaration of martial law in Poland. Enforcement of export controls recently has been tightened. On other East-West issues [REDACTED]

[REDACTED]

The real test of Nakasone's willingness to subjugate economic interests to broader political objectives will come two or three years from now, when domestic business conditions have improved and some of the current pessimism surrounding future demand for resources and energy has

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dissipated. Nakasone then may have to compromise with domestic advocates of expanded economic ties with Moscow by permitting increased activity on the private level. Japanese banks are showing increasing interest in the Soviet Union as a potential borrower and are likely at some point to lobby for removal of existing guidance against direct loans. A substantial expansion of trade would then be possible without any relaxation of the existing curbs on official financing. [REDACTED]

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## Japan: Marking Time in Economic Relations With the USSR [REDACTED]

### The Political and Security Setting

Japanese-Soviet political relations are now at a low point, with little prospect they will improve soon. Although mutually profitable economic relations have provided an element of stability and an incentive for dialogue between the two governments, economic circumstances have changed. Moreover, security issues have assumed a more prominent place in the relationship as Prime Minister Nakasone has moved to strengthen the US-Japan alliance. Tokyo has also expressed concern about Soviet deployment of SS-20s and Backfire bombers in the Far East. [REDACTED]

### Security Concerns

More than any of his predecessors, Nakasone has made security issues a major government concern. He has said that Japan must have the military capability to defend itself in a conventional war and must be capable "of contributing in some measure to the security and well-being of other states." Some Japanese officials, particularly in the Ministry of Foreign Affairs, had worried that the new Prime Minister's penchant for personal diplomacy might lead to an initiative to improve relations with Moscow. They have found, instead, that Nakasone was willing to use the Soviet military buildup in Asia, the Northern Territories issue, and the SS-20 issue to bring attention to Japan's security problems. In his first few months in office, for example, he increased defense spending by 6.5 percent, improved relations with South Korea, decided that Japan should make technology available to the United States for military applications, [REDACTED]

[REDACTED] referred to closing the approaches to the Sea of Japan in wartime, and in general left no doubt that strengthening the alliance with the United States and shoring up Japan's defense capabilities were personal priorities. [REDACTED]

Even before Nakasone took office, the Soviet Union had registered concern about the increase in defense expenditures by the Suzuki administration and the

closer strategic cooperation between the United States, Japan, and China in the Far East. On the eve of Nakasone's accession, the Soviet Embassy in Tokyo protested Japan's decision to allow the basing of US F-16s at Misawa. Nonetheless, the Soviet media gave the new Prime Minister a month's grace, mixing praise for his experience and influence as a politician with reminders of his past support for revising Japan's constitutional prohibition against war as an instrument of foreign policy and his support for a strong Japanese military. [REDACTED]

In January, however, Moscow switched to a harsh propaganda campaign and threatened to use force in an effort to counter Nakasone's move toward closer military cooperation with the United States and improved relations with South Korea. In response to the remark about the "unsinkable aircraft carrier," a TASS report on 19 January carried threats of possible nuclear attack against Japan. Two days before that, in Bonn, Soviet Foreign Minister Gromyko for the first time publicly raised the issue of redeploying SS-20s to the Far East. Articles denouncing the revival of Japanese militarism and the threat it posed to other Asian nations began to appear with increasing regularity in the Soviet press. [REDACTED]

As part of an effort to turn Japanese public opinion against increased military cooperation with the United States, the Soviet Embassy in Tokyo sent letters to two opposition parties in Japan promising that the Soviet Union would not launch a nuclear strike against Japan as long as Tokyo observed its three nonnuclear principles—no possessing, producing, or permitting the introduction into Japan of nuclear weapons. At the same time, by charging that nuclear-equipped US forces were already based in Okinawa, Moscow implied that the nonnuclear principles were not being faithfully observed and that the Japanese people should not be content with the policies of the Nakasone government. [REDACTED]

### The Northern Territories

In addition to the increased interest in security issues, Tokyo has taken every opportunity to press the USSR strongly for the return of the Northern Territories. On 23 April, Nakasone and Chief Cabinet Secretary Gotoda reaffirmed Tokyo's longstanding demand that the Soviet Union return the Northern Territories—three small islands (Kunashiri, Etorofu, and Shikotan) and a small archipelago (the Habomais)—to Japanese control [REDACTED]

Japanese officials have repeatedly emphasized that bilateral relations will not improve substantially until the Soviet Union at least recognizes the existence of a territorial issue. Japanese diplomats keep the issue front and center by insisting that Foreign Minister Gromyko visit Tokyo before any high-level Japanese official visits Moscow. The Soviets have countered since 1978 that a Gromyko visit can take place only after the proper "atmosphere" is created and some possibility of a breakthrough on political issues is imminent, in other words not until they receive assurances that the Northern Territories issue will not be raised and Tokyo displays some interest in negotiating a Good Neighbor treaty, confidence-building measures, or a "no nuclear" weapons agreement. [REDACTED]

### The Political Setting

Tokyo faces little domestic opposition to its policy on the Northern Territories and generally believes the onus is on Moscow to improve bilateral relations. This unusually hardline consensus owes much to the harshness of Moscow's actions and statements in recent months. [REDACTED]

### The Economic Relationship

The increased salience of security issues on both sides of the bilateral relationship comes at a time when the prospects for improved economic ties are uncertain. Exports continue to grow—by almost 36 percent in 1982—but imports declined by 7 percent. Tokyo, meanwhile, shows diminishing interest in deepening Japan's involvement in the Soviet economy. For one thing, Japan's raw material and energy requirements have been reduced by recession and structural changes in the economy. Acting in tandem with the United States and NATO, Tokyo imposed sanctions against the USSR after the Soviet invasion of Afghanistan. The sanctions included:

- Restrictions on official export credits to the Soviet Union.
- Reaffirmation of a ban against the export of high-technology items included on the COCOM list.
- Restrictions on contacts between high-level government officials.

Although the restrictions on export credits and official contacts have been relaxed to some extent, they remain an impediment. Japan's current insistence that Gromyko visit Tokyo before high-level Japanese visitors go to Moscow enforces a tacit limit on diplomatic contacts. Tokyo continues to observe the letter of the COCOM restrictions and recently has begun to discourage some types of transactions not yet officially on the list [REDACTED]

In the case of official export credits, Tokyo has modified its policy from time to time to assuage private-sector complaints that Japanese restraints are more severe than those observed by West European countries. But Tokyo has done so without destroying the framework of the sanctions. In September 1980, for example, Tokyo decided that the sanctions applied only to new credits and approved an extension of

buyers credits to support a \$40 million supplement to the South Yakutsk coking coal project and the third phase of the Siberian timber project. Stretching the old-new distinction even further to accommodate a major business interest, Tokyo justified Japan Export-Import Bank credits to finance the sale of large-diameter pipe on the ground that the pipe was part of an ongoing series of transactions. Approximately \$160 million has been allocated to finance pipe sales in fiscal year 1983, which began in April. Modifications also have been made as West European governments and the United States eased sanctions. [REDACTED]

One measure of the continuing efficacy of the export credit sanction is that Japanese firms have signed only one plant export contract in excess of \$100 million since 1980. Since Tokyo reaffirmed its commitment in early 1982 to restrict export credits after the declaration of martial law in Poland, the Japan Export-Import Bank has made almost no new commitments to finance plant exports. [REDACTED]

#### **Export Credit Policy**

Japan is also cooperating with US efforts to tighten the terms under which official credits are granted. In recent negotiations, the Ministry of Finance insisted on strict observance of OECD guidelines on interest rates. Tokyo does argue, however, that the current premium of 0.3 percentage point that it must add to the long-term prime rate (now 8.4 percent) in calculating the rate for Export-Import Bank loans makes official financing more expensive than loans from private banks. [REDACTED]

Moscow has responded by waging an increasingly intense campaign to undermine domestic support for Tokyo's hard line on official credits. Rather than protesting directly to the government, the Soviets have attempted to mobilize the Japanese business community to push for a change. One tactic is to remind businessmen that Japan, which was once the

USSR's second-largest Western trading partner, is now fourth and has lost ground to European competitors because, unlike France and West Germany, it has refused to separate trade from political issues. [REDACTED]

We believe the Soviet campaign is almost certain to fail barring an unforeseen shortage in Japan of energy or resources. The business community is not of one mind over the need for government initiatives to improve economic relations with the USSR. [REDACTED]

The Ministry of Finance, the final authority within the bureaucracy on export credits and financial issues, has no interest in upsetting its excellent relationship with US financial authorities for the relatively small gains that would come from easing sanctions. Even the Ministry of International Trade and Industry (MITI), the traditional promoter of expanded trade, is relatively inactive at the moment, perhaps because it is under so much pressure from Washington on other issues. [REDACTED]

**Private Financing.** Trading companies have minimized the effect of the decline in Japan Export-Import Bank lending to the Soviet Union on trade by financing more of the trade themselves. [REDACTED]

[REDACTED]

reflects the suspicions of trade officials and businessmen that Washington hopes to cripple existing Japanese trade and resource development deals with the USSR and close off potential markets for new Japanese industries. [REDACTED]

[REDACTED]

Tokyo also resists some parts of the US proposal to control equipment and technology related to the oil and gas industry. The proposed monitoring requirements for pipeline-related equipment in particular hit Japan's steel and machinery industries hard. We suspect Tokyo is also concerned that parts of the proposal might impede completion of the Sakhalin offshore oil and gas development project. [REDACTED]

#### **Declining Interest in Resource Development**

Resource development projects in the USSR have lost most of their luster for the Japanese. Their industrial structure has undergone such a vast transformation as a result of higher energy prices that even the scale of existing projects to import raw materials from the Soviet Union is beginning to appear excessive. [REDACTED]

[REDACTED]

In some cases, the inconsistency of Soviet policies has dampened interest. Japanese businessmen were prepared to move ahead with a pulp and paper complex on Sakhalin two years ago, but the Soviets said no. [REDACTED]

#### **Protecting Existing Economic Interests**

Although not actively pushing economic ties with Moscow, Tokyo does not want to damage existing interests. On the question of broadening the scope of COCOM restrictions, for example, Tokyo is suspicious of US motives. Reporting in the Japanese press



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The Soviets also have recognized that prospects for large-scale development projects are bleak, [REDACTED]

[REDACTED] Soviet officials are now talking about the possibility of launching "miniprojects" to develop Siberian resources. The concept is too ill defined, however, for the Japanese to consider it seriously. [REDACTED]

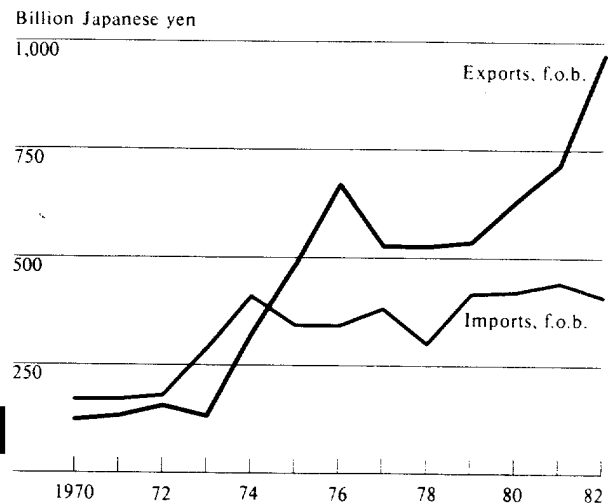
Only the Sakhalin offshore oil and gas project has any momentum at present. The oft-delayed exploratory phase of the project should be completed this summer. Tokyo, prodded by a consortium of major firms and banks that has \$100-200 million invested in the project, remains committed to proceeding with the development phase, even though the utility companies, the ultimate consumers of the liquefied natural gas (LNG) portion of the output, appear to have adequate supplies assured into the early 1990s [REDACTED]

From the government's perspective the project is another opportunity to diversify sources of LNG. Japan now depends on Indonesia for 45 percent of its natural gas. Moreover, Sakhalin is closer to Japan than Alaska, Australia, or Malaysia, and it does not pose the same risk of political instability as Abu Dhabi and Indonesia. Sakhalin would provide LNG at prices lower than those available from many alternative suppliers, not only because of discounts built into the contract, but also because Moscow has a record of underpricing competitors to ensure a market for its gas. Equipment sales will also provide employment opportunities in Japan. Soviet hard currency earnings from the project, which could exceed \$1 billion a year in the mid-to-late 1990s, could also pay for a substantial increase in Japanese exports to the USSR.

#### Trade

Trade with the Soviet Union is growing but is still relatively unimportant to the Japanese economy. In 1982 total trade between the two countries rose 16 percent in yen terms (see figure 1) and 6.7 percent in US dollars to \$5.3 billion. The Soviet Union, however, accounted for only 2.1 percent of the value of Japan's total foreign trade, and the Soviet share in any given year has never exceeded 3 percent. With the exception of platinum-group metals and nickel, Japan's dependence on the USSR for supplies of individual imported commodities remains low. On the export side only two

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Japanese industries—steel and machinery—have important stakes in the Soviet market. The Japanese enjoy substantial annual trade surpluses—\$2.2 billion in 1982. [REDACTED]

Japan's growing trade surplus may become an impediment to further expansion of trade with the USSR. Although in deficit with Japan, the Soviet Union is running surpluses in trade with West European countries. Italy has already complained to Moscow that its deficit is in effect financing Japan's exports to the USSR. The Italians are demanding that the Soviets grant them a larger share of pipeline-related contracts to correct the imbalance. Japanese businessmen expect other West European countries will make similar demands. The Soviets are likely to respond; they generally seek bilateral balance in their trading relationships. [REDACTED]

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**Exports.** The value of Japanese exports to the USSR rose by 35.6 percent (year-to-year comparison of yen values) to \$3.9 billion in 1982. Producer goods made up the majority of Japanese shipments; iron and steel alone were worth \$1.7 billion—over 40 percent of all exports. Large-diameter pipe for natural gas pipelines, seamless pipe for oil wells, steel plate for the manufacture of large-diameter pipe, and special steels were the principal iron and steel products. Japanese industry expects the volume of steel exports to remain high as work on the Siberia–Western Europe and Soviet domestic gas pipelines continues. Shipments of large-diameter pipe should remain at 1 million metric tons per year for at least two more years. Plate shipments exceeded 540,000 tons in 1982; according to a Japanese industry newspaper, the Soviets are seeking an assured supply of 600,000 to 700,000 tons a year. [REDACTED]

The worldwide recession has increased the importance of the Soviet market to Japan's steel industry. The Soviets purchased 8.8 percent of the industry's total exports, as compared with 6.9 percent last year and 5.5 percent in 1980. Dependence on the USSR for export sales should drop back into the 5- to 6-percent range once markets improve elsewhere. By product, Japanese dependence on the Soviet market is greatest in the case of large-diameter pipe. The Soviet Union has been the principal buyer of this item for many years [REDACTED]

Japan's machinery exports to the Soviet Union rose by almost 58 percent to \$1.5 billion in 1982. Unlike in the past, when plant exports accounted for the growth, construction machinery, cargo-handling machinery, and dump trucks led the way. Japanese observers note that the Soviets are buying much of this machinery as part of Phase III of the Siberian timber resources project. The timber resources development contract signed in March 1981 specified that plant and equipment purchases had to be made within two years. [REDACTED]

Machinery exports probably will decline this year. Demand for machinery to be used in timber resources development will plummet [REDACTED]

[REDACTED] Soviet officials have expressed interest in smaller scale plants to produce electronic goods and in automated production facilities, but actual exports will be limited by Tokyo's adherence to COCOM. Japan's Ministry of Foreign Affairs has refused visas to Soviets seeking to visit facilities containing sensitive technology, and MITI is taking measures to upgrade COCOM enforcement. [REDACTED]

Machine tools essential to improving industrial productivity are a substantial percentage of exports to the USSR. The Soviets purchased large numbers of grinding machines and machining centers in 1982. The Soviets also rely on Japanese suppliers for numerical controls and industrial robotics. Kawasaki Heavy Industries, for example, has sold 42 spot welding robots for use in motor vehicle assembly in the last three years, according to a US businessman. Nonetheless, the Soviet market is not of great importance to the machine tool industry as a whole; shipments were only 4 percent of Japanese machine tool exports in 1982. In the case of individual firms, few if any depend on the Soviet Union as a market. [REDACTED]

**Imports.** The value of Japanese imports from the Soviet Union fell in 1982 by 7 percent to \$1.7 billion (c.i.f.). The drop reflected falling demand induced by recession and falling prices for semimanufactured goods and raw materials, which have traditionally accounted for more than half of the value of imports. The USSR accounts for only 1.3 percent of Japan's total import bill. Prospects are not good for a turnaround soon [REDACTED]

**Table 1**  
**Japan: Imports of Nonmonetary Gold**

	Worldwide		From the USSR	
	Quantity (tons)	Value (FOB) (Million US \$)	Quantity (tons)	Value (FOB) (Million US \$)
1976	63	250	0.3	1
1977	47	223	1	6
1978	81	498	5	31
1979	53	426	4	41
1980	28	524	2	46
1981	172	2,425	37	535
1982	143	1,514	32	348

A substantial part of the decline in the value of imports is linked to a fall in the price of gold, which accounted for 24 percent of all Japanese imports from the Soviet Union in 1982. Small amounts of Soviet gold also may have reached Japan indirectly through the London and Zurich markets, the largest sources of Japanese imports. Over two-thirds of the fall in the value of direct gold imports from the USSR is attributable to a decline in the price of gold. Japanese buy gold primarily as a financial asset. Consequently, a downward movement in the world price reduces its attractiveness as an investment and cuts import volume.<sup>1</sup>

In 1982, wood was again Japan's leading import from the USSR, having been temporarily displaced by gold in 1981. Wood imports are especially important to the pro-Soviet lobby. Member firms in the association that handles 80 percent of the trade channel part of their profits to the Japan Socialist Party and other

promoters of better Japanese-Soviet relations, according to a recent Japanese magazine article. As table 2 shows, however, recession and a stagnant housing market in Japan have taken their toll. Japan imported only \$396 million worth of logs, lumber, and wood pulp in 1982, compared with \$747 million in the peak year of 1980 and \$485 million in 1981. Here, too, much of the decline is the result of a fall in prices. The price of pine logs, for example, fell by 34 percent between 1980 and 1982.

Japan's wood imports should increase modestly in 1983. Housing investment turned upward in the fourth quarter of 1982 and is expected to continue rising in early 1983. For the year the increase in housing investment should be 6 to 7 percent. Less certain, however, is the Soviet Union's ability to maintain its share of the market. Japan's total wood imports rose in value approximately 11 percent in 1982, while the value of Soviet shipments declined substantially.

<sup>1</sup> Japan became a major market for gold in 1981, the first year Japanese citizens were allowed to buy gold freely. Gold trading got another boost in April 1982, when major commercial banks introduced passbook accounts for gold. Gold is an appealing investment for Japanese who wish to evade taxes because dealers are not required to report transactions to tax officials. This reason for investing was especially compelling in 1981 and 1982 because the Ministry of Finance was threatening to close a loophole that has allowed people to invest billions of dollars illegally in tax-exempt savings accounts. The Diet, however, postponed implementation of the Ministry of Finance's plan for five years. Most people probably will choose to keep their money in the interest-earning savings accounts for a few more years, thus reducing the potential demand for gold.

The Soviet Union continues to be a major supplier of platinum-group metals—platinum, palladium, and rhodium—which are essential to Japan's advanced technology sectors. By value the Soviet Union supplies 46 percent of Japan's rhodium, 55 percent of its palladium, and 24 percent of its platinum. Imports of

**Table 2**  
**Japan: Wood Imports From the USSR**

	Value (FOB) (Million US \$)	Percent of Total Wood Imports
1976	416	12
1977	538	14
1978	528	13
1979	732	10
1980	747	9
1981	485	10
1982	396	8

platinum group metals were worth \$114 million in 1982. Dependence on the Soviet Union for other metals is low. As a rule of thumb, Japan tries to keep its dependency on the USSR below 20 percent. Only in the case of nickel is dependency at this level. Nickel, however, presents no real problem. Canada is the largest supplier, and the Philippines, Australia, and the United States are alternative sources.

#### **Prospects**

In the immediate future, we expect Prime Minister Nakasone to uphold the need for a common front among Western nations in dealing with the USSR. Nakasone appears to share the view of the Ministry of Foreign Affairs that closer cooperation among Western countries will, over the long term, strengthen Tokyo's position in dealings with Moscow.

Nakasone's interest in a common approach extends to the INF negotiations. We believe the sudden expression of high-level Japanese concern about the INF negotiations and the basing of SS-20s probably has less to do with the potential threat from the USSR than with the need for reassurance that the United States gives as much priority to the defense of Japan and the western Pacific as it does to the defense of Western Europe and the Atlantic.

Recession and, more recently, the Levchenko allegations have spared Nakasone the hard decisions usually necessary to bring export credit and control policies into line with a tougher political stance toward Moscow. The real test of Nakasone's willingness to subordinate economic interests to broader political objectives such as the recovery of the Northern Territories will come two or three years from now, when domestic business conditions have improved and some of the current pessimism surrounding future demand for resources and energy has dissipated.

Nakasone will not, in our view, turn away from Japan's commitment to a harder line politically. He will, however, eventually have to compromise with the advocates of expanded economic ties with Moscow by permitting increased activity on the private level. Japanese banks are showing interest in the Soviet Union as a potential borrower and are likely at some point to lobby for removal of the Ministry of Finance guidance against direct loans. If the Sakhalin offshore project and the Siberian-Western Europe pipelines move ahead, the Soviet Union would be in a better position to repay long-term credits. Thus, it is quite possible that commercial banks could displace the Japan Export-Import Bank as the primary supplier of credit for plant exports and smaller resource development projects. A substantial expansion of trade would then be possible without any relaxation of the existing curbs on official financing.